

**EXECUTIVE SECRETARIAT****ROUTING SLIP**

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI				
2	DDCI				
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9	Chm/NIC				
10	GC				
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12	Compt				
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15	VC/NIC				
16	NIO/ECON		X		
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SUSPENSE		_____			
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Remarks

**STAT**

Executive Secretary

29 OCT 85

Date

3637 (10-81)

THE WHITE HOUSE  
WASHINGTON

4163

## CABINET AFFAIRS STAFFING MEMORANDUM

Date: 10/28/85 Number: 317013CA Due By: *Forwarded*  
Subject: Economic Policy Council Meeting -- October 29, 1985

3:00 P.M. -- Roosevelt Room

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Justice	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input type="checkbox"/>	<input checked="" type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	McFarlane	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input type="checkbox"/>	<input type="checkbox"/>	Svahn	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HUD	<input type="checkbox"/>	<input type="checkbox"/>	Chew (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Energy	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Chief of Staff	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Education	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<u>CIA</u>	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
GSA	<input type="checkbox"/>	<input type="checkbox"/>	Executive Secretary for:		
EPA	<input type="checkbox"/>	<input type="checkbox"/>	DPC	<input type="checkbox"/>	<input checked="" type="checkbox"/>
NASA	<input type="checkbox"/>	<input type="checkbox"/>	EPC	<input checked="" type="checkbox"/>	<input type="checkbox"/>
OPM	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
VA	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
SBA	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

## REMARKS:

The Economic Policy Council will meet on Tuesday, October 29, at 3:00 P.M. in the Roosevelt Room.

The agenda and background papers are attached.

## RETURN TO:

☒ Alfred H. Kington  
Cabinet Secretary  
456-2823  
(Ground Floor, West Wing)

☐ Don Clarey  
☐ Rick Davis  
☐ Ed Stucky

THE WHITE HOUSE

WASHINGTON

October 28, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER *EM*  
SUBJECT: Agenda and Paper for the October 29 Meeting

The agenda and paper for the October 29 meeting of the Economic Policy Council are attached. The meeting is scheduled for 3:00 p.m. in the Roosevelt Room.

The single agenda item is the farm credit situation. The Working Group on Agricultural Credit has been meeting with representatives of the Farm Credit System (FCS) and the Farm Credit Administration (FCA) to review the financial condition of the FCS and explore possible restructuring initiatives. A report from the Working Group, describing its conclusions and outlining a proposed Administration position on the FCS is attached.

Attachment

THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

October 29, 1985

3:00 P.M.

Roosevelt Room

AGENDA

1. Farm Credit Situation

THE WHITE HOUSE

WASHINGTON

October 28, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: THE WORKING GROUP ON AGRICULTURAL CREDIT POLICY

SUBJECT: Farm Credit System

Since the Economic Policy Council meeting of October 10, the Working Group has been in continuous and intensive study and discussion with representatives of Farm Credit Administration (FCA), Farm Credit System (FCS), and their lawyers and accountants. We have clarified and solidified our understanding and conclusions about the scope of the problem, the capacity of the System to absorb loan losses, and the package of reforms and restructurings necessary to resolve the issue as efficiently and effectively as possible. We have arrived at a consensus on the important pieces of this complicated puzzle, and at a recommended strategy that we recommend.

The basic conclusions and recommendations of the Working Group are as follows.

I. SCOPE OF THE PROBLEM

- o FCA and FCS estimates regarding the size of their potential problems due to bad assets and the potential losses to the System are not unreasonable. The exact size and timing of losses is, however, tied somewhat to the future course of the economy and the farm sector.
- o The System will have to report substantial overall losses over the course of the next three years, representing approximately \$3 billion for 1985 and \$1.5 billion in each of 1986 and 1987.

Capacity of the System to Handle the Problem

- o The System does appear to have sufficient earned surplus and earnings in spite of the bad assets to enable it to absorb those assets without jeopardizing stock held by borrowers.
- o The System's assessment of its ability to absorb losses is far too conservative because they: (1) believe FCS needs low leverage to borrow (8:1), where in fact "agency" borrowers borrow effectively with much higher leverage (70:1); (2) only grudgingly tap the surplus of System banks (\$4.1 billion at year-end 1984) and resist tapping the surplus of System associations (\$2.1 billion at year-end 1984) (there also were loan loss reserves of \$1.3 billion); (3) believe competition will force them to compress the net interest margin

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considerably below 1985 levels, which are low by historical standards; and (4) fear the flight of good borrowers (with their borrower stock, which FCS is reluctant to tap anyway).

- o If bond market investors believe FCS has lost the "implied" backing of Government, FCS is correct to fear an adverse market reaction to its losses and erosion of capital. But if bond market investors receive sufficient assurance and permit FCS to rollover its debt, total FCS (banks and associations) surpluses and loss reserves should provide a sufficient cushion. Even if agricultural conditions worsen beyond FCS's projections, it should take another year or two to work through FCS's total surplus.
- o FCS fears about competition and borrower flight have some validity, but not enough to require Federal funds now. Many FCS competitors are also ailing. As an "agency" borrower, an efficient FCS should be able to compete. Furthermore, the number of FCS borrowers who can pay off their loans or find an alternative source of credit for land loans (about \$50 billion of FCS's portfolio) is probably limited in today's market environment.
- o The current surplus should also enable the System to continue operating as a viable lender, with the possibility of its returning to a breakeven or minimally profitable operation in 1988. Using basically FCA and FCA's own estimates for 1985-87 and a simple extrapolation to 1988 produces the following selected financial statistics for the consolidation of the 37 banks and all local associations:

(\$ Millions)

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Net Income	373	(2,800)	(1,348)	(1,412)	small but positive
Surplus	6,200	3,400	2,100	700	700+
Total Capital	11,800	8,700	7,000	5,100	5,100+
Loan Loss Reserves	1,300	3,300	3,000*	2,300*	*
Capital as a % of Assets	13.5%	10.6%	9.2%	7.8%	7.8%+

- \* These numbers depend on the rate at which charge-offs are incurred to reflect foreclosures and restructurings. We used FCS's assumptions about holding non-earning assets, which do not envision an aggressive disposal process.

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## II. LEGISLATIVE PROGRAM

- o It is preferable that a consensus solution to the System's problems be achieved this year in order to ensure congressional acceptance and avoid a carry over of the issue into the 1987 spring planting season.
- o There appears to be substantial agreement between the Administration, the FCA, and FCS regarding improved use of the System's surplus and capital funds and broad major regulatory reforms.
- o Some areas of current potential disagreement remain. There are also details underlying major areas of agreement which must be resolved.

The broad principles for a legislative program recommended by the Working Group are as follows:

### 1. Managing Surplus and Capital Accounts

The best mechanism for handling the System's bad asset problem is to permit the Farm Credit System's Capital Corporation (FCSCC), established under the FCS, to:

- a) acquire from the System loans and property at no greater than market value;
- b) assume obligations for consolidated FCS debt so as to carry the assets while they are being held, leased, or restructured in an orderly fashion;
- c) extract earned surplus from those operating units which have it and transfer it to those which are in deficit;
- d) assess the operating units sufficiently to capture their future earnings as support for FCSCC's debt service obligations and operating losses, subject to existing FCA regulations to transfer capital.

### 2. Reforms in Regulatory Authorities

The best mechanism for ensuring a permanent solution to the System's operating problem is to provide a strong and effective regulatory agency with authority broadly similar to that regulating nonfarm financial institutions.

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The reformed regulatory authority should be provided with general powers that include:

- a) restructuring of present management board with a single Chairman appointed by the President;
- b) general rulemaking authority and examination and enforcement powers;
- c) power over exit and entry to the system, including approval and/or requiring mergers;
- d) authority to establish capital requirements and safety and soundness provisions.

Additional details regarding proposed reforms are contained in an appendix.

### 3. Options for Federal Assistance

The Working Group does not believe that we can provide sufficient incentive and reassurance to the Congress, the FCS, or the debt markets to be able to get and keep all of the necessary, linked and complicated pieces of a solution together without some express Government support for the System.

The Working Group recommends the following option for Federal assistance:

Option 1: Seek authority for the Secretary of the Treasury at his discretion to purchase up to \$3 billion of Farm Credit System Capital Corporation (FCSCC) securities on terms and conditions set by the Secretary, but contingent upon:

- the System fully utilizing all of its earned surplus down to borrower stock;
- the Secretary's satisfaction that all reasonable efforts have been made to maintain System earnings on good assets and obtain liquidity from System assets such as bank buildings and mineral rights on acquired property; and
- the Secretary's determination that it is in the public interest to do so.

In putting this option into effect, the Administration would establish a set of controls



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and restrictions on FCS that would give them the incentives to pay the Government off as soon as possible and build up a surplus position in the future.

The Working Group also considered but rejected the following options:

Option 2: Do not provide any form of Federal financial assistance until the System has depleted its surplus and cannot maintain its liquidity.

Option 3: Establish a line of credit from the Treasury to the FCSCC matching the FCS's contribution of excess surplus to the FCSCC. Any funds borrowed through the revolving fund at the Treasury would be subject to repayment at such terms and conditions as the Secretary of the Treasury may prescribe.

### III. EDUCATION PROCESS

The Administration, primarily the Departments of Agriculture and Treasury, should begin aggressively to educate the Congress and the farm and financial communities of our interest in assuring a viable FCS, conveying our more optimistic assessment of the status of the FCS, and arguing for restructuring. The following points in particular should be made:

- a) The Administration is confident that the FCS has the resources to deal with its own problem.
- b) We will support efforts to reform and restructure the system to enable it to better utilize and manage its own resources.
- c) Should they need help in the future, the Administration is ready to assist them by purchasing FCS securities.
- d) Cooperating with the FCS and the FCA to work out FCS's problem:
  - ensures an adequate source of credit to farmers at reasonable interest rates;
  - protects borrower's stock in the FCS; and
  - alleviates some of the credit stress currently depressing much of American agriculture.

- e) Administration statements should emphasize how the farmer

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USDA has been asked to testify later this week before the Senate and House Agriculture Subcommittees and a House Banking subcommittee. The education process should begin with this testimony.

Attachment

ATTACHMENT

Additional Details Regarding Proposed Reforms  
in Regulatory Authorities

1. Replace the present management structure with a single chairman appointed by the President.
  - o Make the existing Federal Farm Credit Board an advisory body subject to the call of the new Chairman for the duration of their current appointments.
  - o Authorize the Chairman to create an advisory committee of representatives from the agricultural sector to serve at his call and advise him on agricultural matters.
2. Provide the regulator with examination and enforcement authority to examine each of the operating system's district banks, associations, Central Bank for Cooperatives, and other entities which may exist or be created under the Farm Credit Act.
3. Provide the regulator with the following general powers:
  - a) rulemaking authority;
  - b) authority over exit and entry into the System and authority to approve and/or require mergers;
  - c) authority to prevent certain persons from working in the regulated entities and authority to terminate an institution's access to the System should the institution violate laws;
  - d) authority to require appropriate information to facilitate examination.
4. Provide the regulator with authority to:
  - a) establish capital requirements for all operating institutions, and related authorities;
  - b) establish safety and soundness provisions setting limits on maturity, collateral, and terms of loans and limits related to investments and securities;

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- c) receive notice of pending debt issues and to intervene to prevent any financing which threatens safety and soundness;
  - d) establish safety and soundness regulations relating to general services and other operating authorities and to assess the full operating expenses of the regulator;
  - e) establish appropriate enforcement powers including civil money penalties on regulated entities or certain officials, to issue cease and desist orders, to suspend or remove individuals, and to prohibit future service, and to terminate activities constituting risk to safety and soundness. Related authorities to general enforcement powers comparable to other financial regulatory agencies.
5. Enact legislation eliminating or consolidating provisions which will no longer be appropriate to the functions of a reformed regulator including prior approval of operating system salaries schedules for Executive/Director compensation, approval of special assignment pay for district directors, prior approval of coordination of bank system's own lending standards prior approval to coordinate and assist in providing management services and responsibility to prepare and disseminate to the public about the operating system and the merits of its securities.
- Also provide authority to eliminate the responsibility for executing systemwide or consolidated securities on behalf of operating system institutions and to approve individual issues, prior approval of PCA lending standards by district FICBs and the authority to delegate certain regulatory powers to the operating system.
6. Provide the operating system's capital corporation with appropriate authority to manage and liquidate problem loans.
7. Provide the capital corporation with authority to issue several classes of stock and debt to the operating units of the Farm Credit System and establish the initial capitalization of the corporation by requiring the investment of operating system surpluses.

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8. Provide the capital corporation with authority to assess operating banks and associations to cover expenses and debt payments and loan losses and stipulate that the capital corporation is a joint and several obligor of the operating system.
9. Provide specific purposes and powers to the capital corporation necessary to carry out its objectives.